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Second Circuit Requires Increased Scrutiny of Securities Class Actions Involving Off-Exchange Transactions

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The Second Circuit held today that putative securities class actions involving transactions in non-U.S.-listed foreign securities require careful scrutiny to determine whether the class members' claims can be litigated on a classwide basis. The court's ruling in *In re Petrobras Securities* (No. 16-1914) will likely increase the difficulty of certifying securities class actions arising from transactions in non-U.S.-listed foreign securities.

The *Petrobras* decision involves the interplay between (*i*) the Supreme Court's pronouncement that the federal securities laws apply only to transactions in U.S.-listed securities and to other U.S. domestic transactions and (*ii*) the federal class-action rule's requirement that common issues predominate over individualized issues in order for a damages class action to be certifiable. The *Petrobras* appeal involved foreign securities that were not listed on a U.S. exchange, so the plaintiffs needed to show that they had purchased their securities in domestic transactions. But determining whether a particular transaction took place in the United States involves individualized issues about whether irrevocable liability was incurred or legal title was transferred in the United States. The Second Circuit held that the District Court had not sufficiently considered the individualized nature of that proof in ruling that the class satisfied the predominance requirement.

Factual Background

The U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank* imposed a new standard for determining the extent to which the U.S. securities laws apply to securities claims involving international elements. The Court articulated a transactional test and held that the federal securities statutes apply only to alleged misstatements or omissions made "in connection with the purchase or sale of [*i*] a security listed on an American stock exchange, and [*ii*] the purchase or sale of any other security in the United States."

Morrison's first prong – for U.S.-listed securities – has led to some litigation, but has been relatively comprehensible. The second prong – for U.S. transactions in unlisted securities – has proven more elusive.

In several post-*Morrison* rulings, the Second Circuit sought to define what constitutes a domestic securities transaction. The court held that plaintiffs can satisfy *Morrison*'s second prong by showing either that they incurred irrevocable liability in the United States for their securities transactions or that title passed in the United States. The Second Circuit propounded a nonexclusive list of factors to assess whether an off-exchange transaction was a domestic transaction under *Morrison*: where the contract was formed; where the purchase order was placed; where title passed; and where money was exchanged. Allegations about a party's or a counterparty's residence or a broker's location are not necessarily sufficient. In addition, the Second Circuit has held that, even if a transaction might technically be considered domestic, some claims might nevertheless be so predominantly foreign as to preclude application of U.S. law in light of *Morrison*'*s* concerns for international comity.

The *Petrobras* appeal concerns *Morrison*'s second prong, because the claims involved the Brazilian issuer's global bonds, which trade over the counter, rather than on a U.S. exchange. Petrobras's exchange-listed securities were not at issue in the appeal.

The case posed the question whether the claims of putative class members who had purchased Petrobras's *unlisted* securities could be litigated on a classwide basis. Petrobras argued that, under Second Circuit precedent, the off-exchange purchasers would need to demonstrate either the incurrence of irrevocable liability or the passing of title in the United States. Such proof would raise so many individualized issues about each class member's transaction that the class members would not be ascertainable before final adjudication and that common issues of fact or law would not predominate over individualized issues. Petrobras thus sought to exclude from the class anyone who had purchased Petrobras securities in off-exchange transactions or from non-U.S. underwriters.

The U.S. District Court for the Southern District of New York denied Petrobras's request, because the court was "confident that the *Morrison* determination [concerning the existence of domestic transactions] is administratively feasible" in a class action. According to the court:

The criteria identified by [the Second Circuit], as relevant to the determination of whether a transaction was domestic, are highly likely to be documented in a form susceptible to the bureaucratic processes of determining who belongs in a class. For example, documentation of "the placement of purchase orders" is the sort of discrete, objective record routinely produced by the modern financial system that a court, a putative class member, or a claims administrator can use to determine whether a claim satisfies *Morrison*.

Petrobras's Petition for Leave to Appeal

Petrobras sought leave to file an immediate, interlocutory appeal under Federal Rule of Civil Procedure 23(f), which allows appellate courts to permit appeals of grants or denials of class certification before entry of final judgment. Focusing on the fact that the putative class members had purchased global bonds, which are designed to be traded throughout the world, Petrobras argued that class certification was inappropriate because individualized mini-trials involving issues specific to each note purchaser would be needed to determine who was in the class and whether each purchaser had incurred irrevocable liability for or obtained title to the notes in the United States.

The Securities Industry and Financial Markets Association ("SIFMA") filed an *amicus* brief in support of Petrobras's petition. SIFMA warned that the District Court's ruling could have wide-ranging implications for $85 trillion of currently outstanding debt securities, which predominantly trade over the counter ("OTC"), rather than on exchanges. SIFMA also charged that the District Court's assumption that the location of transactions could be documented through "the bureaucratic process" is "at odds with the reality of the OTC market," because "[d]ealers are not required by SEC or FINRA to maintain, and they do not maintain, records of whether a transaction is 'domestic' under *Morrison*. Nor do trade confirmations indicate this."

The Second Circuit granted leave for an immediate appeal and later stayed the trial of the class action pending the ruling on the appeal. In today's decision, the court vacated the grant of certification as to the global noteholders and remanded for further proceedings.

The Second Circuit's Decision

The Second Circuit agreed with the District Court's ruling that the class was sufficiently ascertainable even insofar as it included global noteholders. However, the Second Circuit concluded that the District Court had not "meaningfully address[ed]" Federal Rule of Civil Procedure 23(b)(3)'s predominance requirement in certifying the class.

Rule 23's Unwritten "Ascertainability" Requirement

The Second Circuit, like most other courts, has "recognized an implied requirement of ascertainability in Rule 23, which demands that a class be sufficiently definite so that it is administratively feasible for the court to determine whether a particular individual is a class member." Some courts, such as the Third Circuit, have adopted a "'heightened' two-part ascertainability test under which plaintiffs must not only show that the class is defined with reference to objective criteria, but also that there is a reliable and administratively feasible mechanism for determining whether putative class members fall within the class definition." Other courts, such as the Sixth, Seventh, Eighth, and Ninth Circuits, have declined to adopt an "administrative feasibility requirement." The Second Circuit sided with the latter camp and refused to do so as well.

The Second Circuit declared that "[t]he ascertainability doctrine that governs in this Circuit requires only that a class be defined using objective criteria that establish a membership with definite boundaries." However, "[a]scertainability does not directly concern itself with the plaintiff's ability to offer *proof of membership* under a given class definition, an issue that is already accounted for in Rule 23." That administrative-feasibility concern arises under Rule 23(b)(3)'s separate "predominance" requirement, not under the Rule's implied ascertainability criterion.

Applying the proper definition of ascertainability (without the additional requirement of administrative feasibility), the Second Circuit concluded that the class members encompassed by the proposed class definitions were sufficiently ascertainable. "The Classes include persons who acquired specific securities during a specific time period, as long as those acquisitions occurred in 'domestic transactions.' . . . These criteria – securities purchases identified by subject matter, timing, and location – are clearly objective." The court noted that, although "[a]ppellants vigorously challenge the *practicality* of making the domesticity determination for each putative class member, . . . the ascertainability analysis is limited to narrower questions of whether those determinations are objectively *possible*."

Rule 23's "Predominance" Requirement

But although the putative classes of noteholders survived the ascertainability analysis, they foundered – at least for now – on Rule 23(b)(3)'s separate predominance requirement, which mandates that "(1) resolution of any material legal or factual questions . . . can be achieved through generalized proof, and (2) these [common] issues are more substantial than the issues subject only to individualized proof." The Second Circuit held that the District Court had not sufficiently addressed whether *Morrison*'s requirement of a domestic transaction is "susceptible to generalized class-wide proof."

Based "on the available record," the Second Circuit opined that "the investigation of domesticity appears to be an individual question requiring putative class members to present evidence that varies from member to member." Such evidence could include "facts concerning the formation of the contracts, the placement o[f] purchase orders, the passing of title, or the exchange of money." The court observed that "[t]hese transaction-specific facts are not obviously susceptible to[] class-wide proof, nor did Plaintiffs suggest a form of representative proof that would answer the question of domesticity for individual class members." "In this case, the potential for variation across putative class members – who sold them the relevant securities, how those transactions were effectuated, and what forms of documentation might be offered in support of domesticity – appears to generate a set of individualized inquiries that must be considered within the framework of Rule 23(b)(3)'s predominance requirement." The court therefore remanded for further consideration of those questions.

Implications

The *Petrobras* decision will likely increase plaintiffs' burden of satisfying the predominance requirement in putative class actions involving transactions in non-U.S.-listed foreign securities. Courts will need to analyze whether common issues predominate over individual ones where "it cannot be said that the class members' *Morrison* inquiries will prevail or fall in unison" and where the circumstances of each putative class member's transactions must be evaluated to determine whether each class member may sue under the U.S. securities laws. The practicalities of this *Morrison* analysis will play an important part in the predominance inquiry.

The Second Circuit hypothesized about ways in which plaintiffs and courts might address this issue in cases concerning non-U.S.-listed foreign securities. "For instance, a district court might find that the transaction records for a particular security among particular parties display certain common indicia of ownership. Class plaintiffs may propose a mechanism for assembling a representative sample of the manner in which a given security will trade, with an emphasis on the domesticity factors highlighted [in Second Circuit precedent]. A district court could also carefully weigh the relationship between common and individual questions in the case and determine that any variation across plaintiffs is, on balance, insufficient to defeat predominance." But the Second Circuit took no position on whether a class could be certified on remand.

The *Petrobras* decision deepens the circuit split on whether Rule 23's implied ascertainability requirement demands only an objectively definable class, or whether it also requires that the determination of class membership be administratively feasible. The Supreme Court might need to resolve this split at some point. However, the difference between the two interpretations of ascertainability might not have too much practical impact, because the administrative-feasibility issue will be shifted to the predominance inquiry if it is not part of the ascertainability analysis.

The court's decision included several interesting footnotes that could have ramifications in future cases.

First, the court observed that "all parties appear to have proceeded on the assumption that *Morrison* applies to [American Depositary Shares ("ADSs")] in the same manner that it applies to common stock," so the court "assume[d] that a purchase of Petrobras ADS qualifies under *Morrison*'s first prong as long as the transaction occurs on the [New York Stock Exchange], a 'domestic exchange.'" This footnote might suggest that the court has not foreclosed an argument that ADSs should be treated *differently* from common stock for purposes of a *Morrison* analysis. Several post-*Morrison* cases have explored that question in connection with arguments that ADSs and other derivative types of securities are merely the functional or economic equivalents of foreign shares traded on a foreign exchange – and should therefore not be subject to the U.S. securities laws. The *Petrobras* footnote might be read as leaving a door open for that argument.

Second, in a one-sentence footnote, the Second Circuit agreed with the District Court that a securities transaction is not a "domestic" transaction under *Morrison* merely because it settles through a domestic securities depository. The District Court had ruled that the mechanics of a settlement "are actions needed to *carry out* transactions, but they involve neither the substantive indicia of a contractual commitment . . . nor the formal weight of a transfer of [legal] title" necessary to establish a "domestic" transaction under Second Circuit precedent.